Pacific's infrastructure proposals clearly intend to tie the alleged benefactors to Pacific's network service offerings, and discourage benefactors from utilizing offerings of potential competitors. A more objective assessment would characterize Pacific's alleged charity as no more than a "promotional" offering, designed to stave off competition from the delivery of advanced technologies to educational institutions. In CPUC proceedings, MCI has objected to this offering on the basis that it violates the CPUC's expressed goal of ensuring that California's infrastructure needs are satisfied in a technologically-neutral, provider-neutral manner.

A comparison of California's experience with that in Oklahoma shows exactly how treacherous the infrastructure issue can be. In Oklahoma, where regulators ordered Southwestern Bell to make specific upgrades to its network, the LEC responded by appealing the state regulatory order to the courts and requesting an immediate stay. According to Southwestern Bell's brief, the network upgrade ordered by the Commission did not come with any ability to raise rates to cover the costs of the upgrade.[34] When a LEC is forced to make infrastructure upgrades that it did not schedule itself, the quid pro quo it will extract is an upfront payment. This "cost plus" dilemma that the LECs are creating on this record is exactly the problem the Commission sought to avoid when it created the price cap regulations.

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[34] Brief in Support of Southwestern Bell Telephone Company's Motion for Stay Pending Appeal, Southwestern Bell Telephone Company v. Oklahoma Corporation Commission, No. 83, 179 (Sup. Ct. Okla.), filed May 16, 1994.

MCI urges the Commission to make certain that competition be the force shaping tomorrow's infrastructure. Once state and local barriers to entry are fully removed,[35] competitors will be in a position to offer state-of-the-art services to these public institutions. What should not be forgotten is that there is no logical nexus between price regulation of the LEC interstate access market and the wiring of the Nation's schools and libraries.

The Commission should refrain from assigning to the LECs any particular responsibility for the development of the NII. The risk that the Commission takes in making the LECs responsible for the NII is that the network would be characterized by limited inventiveness of design and uneconomically high costs. Innovation would be limited because the LECs, if left to design and implement the NII in a rival-free vacuum, will lack the catalysts that competition spurs.[36] The cost to society will likely be much higher than if the NII were allowed to develop in a market-driven environment. Thus, MCI urges the Commission to establish a framework in which interstate access competition may flourish. Ameritech is alone among the LECs in recognizing that "[t]he development and deployment of

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[35] MCI has stated that the following barriers to effective competition must be addressed by policymakers: (1) eliminate monopoly franchises, set equitable franchise fees, and remove restrictions that give LECs guarantees of "revenue neutrality"; (2) ensure access to conduits and rights of way; (3) grant customers the freedom to choose a carrier; (4) require open and equal access to LEC networks; (5) grant co-carrier status to alternate providers; (6) establish costing and pricing safeguards to prevent LEC discrimination; and (7) provide universal service in a competitively-neutral fashion.

[36] MCI Comments, pp. 11-14.

a ubiquitous national information infrastructure depends on the development of competition."[37] Only in this way will the numerous participants in the telecommunications market be able to make significant contributions to the nature, ubiquity, and sophistication of the NII. Until effective competition develops, MCI believes that crafting a challenging price cap plan is the best way to ensure the LECs will make efficient and appropriate investments in the NII. In their drive to outperform the price cap benchmark, the LECs will channel funds into their networks, thereby benefitting all network users.

**Baseline Issue 1b: Whether the goal of providing universal service to all geographic areas and of equal type and quality for all Americans at affordable prices is being met, or whether the Commission should revise the LEC price cap plan to ensure the provision of universal service.**

In its comments, MCI argued that the Commission should re-evaluate universal service subsidy policies in a separate proceeding that focuses on the myriad of issues involved in the provision of universal service.[38] See infra Baseline Issue 12.

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[37] Ameritech Comments, p. 6.

[38] MCI Comments, p. 14.

## BASELINE ISSUE 2: COMPOSITION OF BASKETS AND BANDS

**Whether the LEC plan should be revised to permit more streamlined and flexible regulation of LEC services when market changes justify such revisions.**

In light of the recent changes the Commission has made to the structure of the price cap baskets,[39] MCI argued in its comments that there was no need to make additional modifications to the baskets at this time. MCI suggested that the current configuration would serve as a "reasonable starting point for the transition to the more flexible pricing rules that may follow the advent of effective competition."[40] Specifically, MCI recognized that the current basket arrangement grouped services subject to similar risk and degree of competition into the same basket, thereby minimizing the LECs opportunity to abuse the available pricing flexibility.[41]

Parties commenting in this proceeding either likewise support no significant change in the basket organization,[42] or support the USTA Pricing Flexibility Proposal ("the USTA proposal"). USTA proposes moving the tandem switching function into the switching basket and supplanting the current service band indexes ("SBIs") with indexes that are associated with geographic markets

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[39] Transport Rate Structure and Pricing, CC Docket No. 91-213, Second Report and Order, 9 FCC Rcd 615 (1994) ("Trunking Basket Order").

[40] MCI Comments, p. 16.

[41] Id. at 17.

[42] See, e.g., NYNEX Comments, pp. 23-24; AT&T Comments, pp. 39-40; and Ad Hoc Telecommunications Users Committee Comments, p. 17.

(corresponding to serving wire centers) and are subject to different levels of pricing flexibility depending on market-specific competition levels. The new indexes would not correspond to the current categories reflected in the price cap plan, but would, for example, replace the present four special access categories with more general "digital" and "analog" classifications. Most price cap LECs commenting in this proceeding support the USTA proposal.[43]

The problem with USTA's proposal, however, is that it collapses the number of service categories to grant LECs additional and unwarranted pricing flexibility.[44] Its three-tiered market structure would collapse the current price cap bands and eliminate the three-zone hierarchy of pricing constraints that the Commission only recently adopted for access services in special access and switched access collocation orders.[45] Indeed, the Commission already has rejected a similar plan that USTA advanced in that proceeding.[46] Nothing has changed since then that would support a change of course now. In fact, as recently as May 27, 1994, the Commission stated that there is no present need

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[43] See, e.g., US WEST Comments, p. 30; Lincoln Telephone and Telegraph Company Comments, p. 13; Rochester Telephone Corporation Comments, p. 18; GTE Comments, p. 62; and Ameritech Comments, p. 11, (footnote omitted).

[44] Also, the proposal proceeds with mixing together services without having first established that they are subject to a similar level of competition, thereby failing to guard against cross-subsidization.

[45] Expanded Interconnection Order, 7 FCC Rcd at 7369 (para. 179) (1992) (authorizing zone density pricing for special access) and 7 FCC Rcd at 7374, 7426-28 (1993) (authorizing zone density pricing for switched transport).

[46] Id.

to expand the scope of LEC pricing flexibility, because to do so would threaten emerging competition.[47] For these reasons, the Commission should reject USTA's attempt to use the price cap review proceeding to re-open this issue.

Also, the Commission should reject USTA's proposal to move transport switching into the switching basket. As the Commission stated in its recent Trunking Basket Order, this modification would allow LECs to mix non-competitive local switching with potentially competitive tandem switching.[48] This is particularly critical in light of the Commission's recent decision to require LECs to deliver switching signalling information that enables competitors to offer tandem switching.[49] As the Commission pursues competition in the switching market, it is necessary that it prevent LECs from subsidizing more competitive tandem switching functions with non-competitive local switching revenues.

BellSouth's proposal for modifications to the price cap basket and band structure essentially collapses the trunking bands into three: dedicated transport, tandem switched transport and the residual interconnection charge. Similarly, it folds the Billing Name and Address ("BNA") database into the information and directory assistance band. Also, it suggests flat rate recovery for the common line basket. Finally, and most significantly, it extends zone pricing to switching and

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[47] Expanded Interconnection with Local Telephone Company Facilities, CC Docket No. 91-141, Transport Phase II, Third Report and Order, FCC 94-118, released May 27, 1994 (para. 63) ("Signalling Order").

[48] Trunking Basket Order, 9 FCC Rcd 615 (1994).

[49] Signalling Order at para. 3.

tandem switched transport, and common line. MCI urges the Commission to reject BellSouth's proposal.[50] Since the adoption of zone pricing and the Commission's recent restructure of the bands and baskets, there have been no changes in the marketplace that would warrant granting the LECs further pricing flexibility at this time. In fact, BellSouth is one of two BOCs[51] who, as recently as the 1994 annual access filing, has not even established the zone pricing the current rules allow for special access services. Moreover, since BellSouth's plan requires an amendment to Part 69, its proposal rightfully belongs in the queue with the other LEC proposals for Part 69 access reform.[52]

## BASELINE ISSUE 3: CHANGES IN PRODUCTIVITY FACTORS OR RATE LEVELS

**Baseline Issue 3a: Whether the productivity factor used to compute the LEC price cap indices should be changed; in addition, or in the alternative, whether a one-time change in the LECs' price cap indexes should be required.**

In its initial comments, MCI argued that the Commission should both increase the LEC price cap productivity factor to 5.9 percent, and require a one-

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[50] While MCI has no particular concern with incorporating BNA into the same basket with information and directory assistance, it objects to any recovery mechanism for common line rates that disregards the non-traffic sensitive nature of the underlying costs.

[51] US WEST is the other carrier.

[52] Several parties have petitioned the Commission to undertake a comprehensive review of the access structure. With such proposals pending, it would be premature for the Commission to modify the price cap structure prior to resolution of the appropriate composition of the LEC access services structure.

time decrease in the LECs' price cap indexes. MCI found that, to date, shareholder benefits had eclipsed ratepayer benefits by nearly $900 million, and that this amount will grow to a level of well over $1 billion if the plan is not amended to balance ratepayer and shareholder benefits. In addition, MCI urged the Commission not to adopt an automatic adjustment to the price cap formula for changes in interest rates, but to consider such adjustments in subsequent periodic price cap plan reviews.[53]

There is a predictable divergence of opinion among the parties commenting in this proceeding on whether and how to change the productivity factor. The LECs argue that the Commission either should not change the productivity factor,[54] reduce it to 1.7 percent,[55] or eliminate it altogether.[56] Consumer advocates,[57] user groups,[58] and IXCs,[59] who bear the burden of unreasonably

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[53] MCI Comments, p. 18.

[54] See, e.g., US WEST Comments, p. 36; and Sprint Comments, p. 12.

[55] See, e.g., USTA Comments, pp. 81-82; Bell Atlantic Comments, p. 15; BellSouth Comments, p. 34; GTE Comments, p. 73; and NYNEX Comments, p. 41.

[56] If the Commission does adopt a productivity factor, Pacific urges that the productivity adjustments be applied to a depreciation deficiency reserve, which would be based on "realistic economic lives of [its] assets." Pacific Telesis Comments, pp. 33-34.

[57] See, e.g., Office of the Consumers' Counsel, State of Ohio Comments, p. 7; and Pennsylvania Office of Consumer Advocate Comments, p.4.

[58] See, e.g., International Communications Association Comments, pp. 11-12; and Ad Hoc Telecommunications Users Committee Comments, p. 21, n.20.

[59] See, e.g., AT&T Comments, pp. 25-26; and MCI Comments, p. 18.

high LEC prices, argue that the productivity factor should be raised in order to properly reflect the LECs' productivity and more fairly distribute the benefits of price cap regulation.

The LECs' argument that the productivity factor should be lowered is based on a study, commissioned by USTA and performed by Christensen, Schoech, and Meitzen, of LEC total factor productivity ("TFP") for the period 1984 through 1992.[60] The Christensen Study uses essentially the same methodology as was used in the 1981 Christensen Study of Bell System productivity,[61] which the LECs submitted in the original price cap proceeding. The Commission did not rely on that study when it originally set the LECs' productivity factor, opting instead to perform its own long-term and short-term productivity studies. MCI sees no reason the Commission should rely now on this version of the Christensen Study.

This study computes TFP as the ratio of an index of total LEC outputs to an index of total LEC inputs. The outputs used in the study are local service, interstate end user access, interstate switched access, interstate special access, intrastate access, long distance service, and miscellaneous services. The inputs

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[60] "Productivity of the Local Operating Telephone Companies Subject to Price Cap Regulation," by Laurits R. Christensen, Philip E. Schoech and Mark E. Meitzen, Attachment 6 of USTA's Comments ("Christensen Study"). Total factor productivity is the ratio of all relevant outputs to all relevant factor inputs. If a firm or industry produces more outputs with the same inputs, or the same output with fewer inputs, its TFP growth will be positive.

[61] USTA Comments, Attachment 6, p. ii.

are capital, labor, and materials. The revenue data for each category of output are divided by a price index (reflecting the overall changes in rates for that category), to calculate quantity indexes for each category. A weighted average of the category indexes (weighted by service revenues) produces an overall output quantity index.

Similarly, individual input indexes were calculated for capital, labor, and materials. For capital, individual quantity indexes were developed for each of six types of capital assets,[62] and a weighted average quantity index of capital inputs was computed, using the cost shares of the six types as weights. For labor, indexes of hours worked by management and non-management employees were determined, and a cost-share weighted average of those indexes was computed. The input index for materials was derived by dividing total LEC operating expenses (less depreciation and payments to labor) by the Gross Domestic Product Price Index ("GDP-PI"). An aggregate input index was then computed by taking the cost share weighted average of the these three (capital, labor, and materials) quantity indexes.

For 1984 through 1992, the Christensen Study concludes that total output, computed as described supra, grew at an annual average rate of 3.5 percent, while inputs grew at 0.9 percent. Thus, the LECs' TFP was an average of 2.6 percent per year. Economy-wide TFP growth, as reported by the Bureau of Labor

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[62] The six classes of capital assets are buildings, general support facilities, central office equipment (including operator systems), transmission equipment, information origination/termination equipment, and cable and wire facilities.

Statistics, averaged 0.9 percent over that same period, and the Christensen Study concludes that the LECs' TFP is 1.7 percent greater than that reflected in the Gross National Product - Price Index ("GNP-PI"). This differential of 1.7 percent, USTA concludes, represents the appropriate productivity factor to be used in the LECs' price cap index.

There is a fatal flaw in USTA's use of the results of this study: the outputs that the study examines are not equivalent to the outputs the LEC price cap plan covers. In addition to the interstate access services which <u>are</u> capped by the plan, the Christensen Study includes four services which are <u>not</u> capped by the plan: local service, intrastate access, long distance service, and miscellaneous services.[63] Any difference between the LECs' productivity in providing these other services and their productivity in providing interstate access service results in a productivity factor that has no applicability whatsoever to the instant proceeding.

This indeed appears to be the case. USTA provided the output indexes for each of the seven services, as well as the relative revenue shares it used to compute the aggregate output index. Using these data, MCI has isolated the aggregate output index for the three relevant interstate access services.[64] This

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[63] The LEC price cap plan also caps the LECs' interstate interexchange and corridor services. That basket, however, faces the same productivity factor as AT&T's services. The long distance service included in the Christensen Study is primarily intrastate intraLATA toll.

[64] Attachment A provides the details of this computation.

index shows an annual average growth rate of 6.4 percent for interstate access services, rather than the 3.5 percent growth the Christensen Study computed for all LEC services. These results imply that the TFP factor for the interstate access services covered by the LEC price cap plan should be 2.9 percent higher than the result in the Christensen Study, or 4.6 percent.[65] Adding the 0.5 percent consumer productivity dividend ("CPD") would result in a minimum productivity factor in the LEC price cap formula of 5.1 percent.

The LECs argue that the Christensen Study indicates that the productivity factor should be 1.7 percent, and that the Commission should use this factor in a per-minute formula. In interpreting this claim, however, the Commission should consider what the practical effect that its adoption would have been under the plan to date. A productivity factor of 1.7 percent in a per-minute formula would be roughly equivalent to a productivity factor of -0.2 percent in the Balanced 50/50 formula the Commission adopted, a full 3.5 percent lower than the Commission's originally adopted offset.[66] Using a -0.2 percent productivity factor, MCI calculates that rates would have been $0.665 billion higher in the first year, $1.330 billion higher in the second year, and $1.995 billion higher in the third year

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[65] The Christensen Study does not disaggregate its input index by service. Thus, there is insufficient data to determine whether the growth rate of inputs differs among the services. However, it seems unlikely that this is the case, and MCI has made no adjustment to the growth rate of inputs in the Christensen Study to compute the TFP for interstate access.

[66] Attachment B contains an explanation of the computation of this differential.

under price caps. The LECs' rates of return would also have been higher, by about 1.4 percent in the first year, 2.8 percent in the second year, and 4.2 percent in the third year.[67] Such a result clearly would have furnished a one-sided benefit for the LECs, rather than the more balanced set of benefits the Commission intended.[68]

MCI's argument that the productivity factor should be raised to 5.9 percent is based on an interpretation of the results of the Commission's original productivity studies that reflects actual LEC performance under the price cap plan. Significantly, other commenting parties arrived at a similar productivity factor using different methods. For example, AT&T determined that a 5.97 percent productivity factor would have been necessary to have maintained LEC earnings at 11.25 percent since price caps began.[69] Also, the Ad Hoc Telecommunications Users Committee noted that there are three components of the productivity factor: (1) LEC telecommunications input price growth rate, (2) LEC telecommunications TFP growth rate, and (3) the consumer productivity factor.[70] Examining these three

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[67] Some of these earnings would have been returned in the form of sharing. However, since sharing adjustments are currently being fully reflected in the LECs' Form 492 earnings reports, the subsequent year's sharing obligation is depressed by these amounts. Price Cap Regulation of Local Exchange Carriers, Rate or Return Sharing and Lower Formula Adjustment, CC Docket No. 93-179, Notice of Proposed Rulemaking, 8 FCC 4415 (1993).

[68] See LEC Price Cap Order, 5 FCC Rcd 6786, 6788 (1990).

[69] AT&T Comments, p. 25.

[70] Ad Hoc Telecommunications Users Committee Comments, ETI Report, p. 48.

factors in seven states, the Ad Hoc Telecommunications Users Committee calculated a productivity factor of 5.3 percent.[71]

In sum, three separate methodologies that are void of USTA's blatant errors support a productivity factor in the range of 5.3 percent - 5.9 percent. Thus, there is ample support in the record before the Commission to justify raising the LECs' productivity factor to 5.9 percent. The LECs' study purporting to support a lower productivity factor is seriously flawed and should be rejected.[72] Thus, MCI urges the Commission to raise the productivity factor to 5.9 percent.

LEC arguments to the contrary should be dismissed. For example, several LECs, attempting to support an even lower productivity factor than they already enjoy, claim that developing competition will make it more difficult for them to achieve their historical levels of productivity.[73] This will occur, they argue, because of reduced economies of density, decline in the availability of downsizing as a method of achieving efficiency, IXC absorption of access gains, continued

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[71] Id., ETI Report, p. 58. Ad Hoc Telecommunications Users Committee advocates a CPD of 1%, and thus proposes a productivity factor of 5.8%. To make the number comparable to the other estimates discussed here, MCI has adjusted Ad Hoc's recommendation to reflect a 0.5% CPD.

[72] USTA Comments, pp. 81-84.

[73] See, e.g., BellSouth Comments, pp. 34-37; Pacific Telesis Comments, p. 32; Bell Atlantic Comments, p. 15; and USTA Comments, pp. 82-83.

regulatory constraints, and, as part of the transition to a competitive market, the removal of the more competitive services from price caps.[74]

These arguments provide strong evidence that competition has not yet arrived in the interstate access market (thereby invalidating many claims for relaxed regulation) because they show that the LECs have no understanding how the advent of effective competition will require them to seek alternative sources of productivity gains. It is absurd to believe that productivity increases will be smaller when the incentives to be more productive are produced through actual competition rather than through the simulated competitive forces that regulation is intended to provide. As competitors enter markets, the methods by which productivity gains are achieved will change. Nevertheless, faced with competition, the LECs will have to find new ways of meeting their productivity goals.

As a factual matter, there is little evidence that the LECs are losing economies of density. The LECs' DS1 and DS3 demand continues to grow, and switched access demand growth is unlikely to fall below its level of the past three years under price caps.[75] Nor have the LECs demonstrated that their workforces

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[74] MCI notes that properly performed, the LECs' study supports a productivity factor in a Balanced 50/50 formula of 3.2% (including CPD). Thus, there is no credible evidence that the productivity factor should be lowered.

[75] BOC DS1 and DS3 demand growth continues to be strong. From 1990 to 1992, DS1 channel termination demand grew at 19% per year while channel mileage demand grew at 24%. DS3 demand experienced even greater growth. Channel termination demand grew at 75%, and channel mileage more than doubled (101%). (1993 demand is not included because the data from which these numbers were derived are now reported in direct trunk transport. Though it is no longer clear what portion of the 1993 data represents DS1 and DS3

are at their most efficient levels, and that no further cuts are possible. In sum, the LECs' ability to achieve the productivity level MCI and others are advocating is not threatened by developments in the access marketplace.

Several LECs argue that increasing the productivity factor or making a one-time adjustment would blunt their incentives to become more efficient in the future, as the LECs would believe that any improvement in productivity would be taken away from them later.[76] MCI does not agree. Changing the productivity factor at this review was always a possibility; the Commission stated at the start of price caps that it intended to review its choice of productivity factor.[77] Further, the adoption of price caps in 1990 was a profound departure from rate of return regulation, and it is not surprising that adjustments to the formula are necessary now. As MCI noted in its comments, the Commission acknowledged that it made several conservative decisions on certain aspects of the plan,[78] notably on its selection of the productivity factor. It is ridiculous to argue that the

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special access, the growth trend has continued.)

Switched access, lacking the substantial rate cuts that characterize DS1 and DS3 service prices, has not experienced such dramatic growth. Instead, commensurate also with the slow growth in the economy, switched access demand growth has averaged 6% per year.

[76] See, e.g., Southwestern Bell Comments, p. 38-40; US WEST Comments, p. 36; Ameritech Comments, p. 12; and Pacific Telesis Comments, p. 28.

[77] LEC Price Cap Order, 5 FCC Rcd 6786 (1990).

[78] MCI Comments, p. 20.

Commission cannot recalibrate the plan if, after seeing the results of its conservative choices, it determines that the productivity factor is set too low.

In any case, in a competitive market an innovative company that can produce at a lower cost is not able to retain its higher profits forever; eventually other firms "learn the secret" and will be able to produce at that lower cost as well. The effect is to drive down prices to consumers and eliminate the short term higher profits the innovative company initially enjoyed. There is no reason for price caps not to replicate this aspect of a competitive market.

The LECs have realized productivity levels well above the 3.3 percent factor reflected in their price cap indexes. This fact is not surprising, since their productivity achievements were well above that level in the past. The LECs' claimed justifications for productivity to be lower in the future are not credible. In addition, in the last three years the LECs have received cumulative benefits of $900 million beyond the benefits they have passed on to ratepayers.[79] This skewed result occurred in part because the productivity factor in the LEC price cap plan was set too low. The Commission should correct this imbalance now and raise the LECs' productivity factor to 5.9 percent, as MCI and others have argued.

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[79] Id. at 4.

**Baseline Issue 3b: Whether the price cap LECs' profit levels are reasonable under the current LEC price cap plan in light of the price cap goal that higher profits are intended to be the reward for attaining increased efficiencies.**

In its comments, MCI argued that the LECs' high earnings under price caps indicated that the productivity factor was set too low, rather reflecting that the LECs responded to the incentives of price caps. Thus, MCI urged the Commission to raise the productivity factor and to require a one-time adjustment to the price cap indexes to correct for the effect of the too-low productivity factor and for the decrease in the LECs' cost of capital to 9.54 percent.[80] Conversely, the LECs argue that their rate of return under price caps has been within the range the Commission expected when it instituted price caps,[81] and that the change in their cost of capital is already reflected in the GNP-PI component of the price cap index.[82] MCI agrees that, if the LECs responded to the incentives of price caps, their earnings would be expected to rise. However, MCI also realizes that if the LECs took no initiatives to increase their productivity, but the productivity factor was set too low, their earnings also would rise. Discerning the difference between the two cases is not important. What is important is the

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[80] Id. at 28.

[81] See, e.g., US WEST Comments, p. 17; Southwestern Bell Comments, p. 28; and NYNEX Comments, p. 36.

[82] See, e.g., Southwestern Bell Comments, p. 41; US WEST Comments, p. 38; Pacific Comments, p. 34; NYNEX Comments, p. 36; and GTE Comments, p.74.

recognition that high profits relative to the cost of capital are the result of rates that are set well above cost.

The LECs argue that their productivity factor is "correct" because their earnings are not outside the range the Commission expected. In the same breath, they argue that no reduction in their rates is necessary to reflect a change in their cost of capital. The LECs cannot have it both ways. If changes in the LEC cost of capital are fully reflected in GNP-PI, then either the price cap should keep LEC earned rates of return close to the true cost of capital, or the LECs are more productive than the 3.3 percent factor reflected in their price cap indexes. The LECs have achieved rates of return well in excess of 11.25 percent, and have done so in an environment of sluggish demand growth, and in which their reported earnings have been reduced by sharing (and the absence of an add-back requirement to offset that sharing)[83] and by their high reported costs in the fourth quarter.[84] That the LECs have achieved such these high rates of return under these circumstances is further evidence that the Commission's choice of productivity factor was too low.

The LECs also argue that their earnings under price caps are not substantially different from the earnings of AT&T under price caps.[85] Since the Commission determined that it did not need to adjust AT&T's price cap based on

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[83] See infra Baseline Issue 12.

[84] MCI Comments, pp. 25-26, 33-34.

[85] See, e.g., US WEST Comments, p. 16; Southwestern Bell Comments, p. 25; and BellSouth Comments, p. 40.

its earnings, the LECs argue, the Commission does not need to adjust the LECs' price caps either.[86] The LECs also note that, if they were allowed to reflect the more reasonable depreciation rates that AT&T does, their earnings would have been even lower.[87]

The LECs are incorrect. AT&T's earnings should be higher than the LECs for two primary reasons. First, and most importantly, it is in a more competitive, and hence riskier business: the interexchange market.[88] Second, AT&T's rates were never adjusted to the 11.25 percent rate of return. If the LECs have been able to achieve rates of return similar to AT&T's, then the LECs' earnings are too high.

Nor does MCI agree that the LECs' depreciation rates are set incorrectly. The LECs' depreciation rates are reviewed and reset by the Commission, based on the LECs' own plant replacement schedules. Examination of LEC data since 1985 indicates that the LECs' depreciation reserve as a percentage of gross plant has been rising consistently throughout the period.[89] In any case, if the LECs

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[86] See BellSouth Comments, p. 47.

[87] See, e.g., BellSouth Comments, p. 40; US WEST Comments, p. 41; Pacific Telesis Comments, p. 30; and Ameritech Comments, p. 13.

[88] Compare Competition in the Interstate Interexchange Market, CC Docket No. 90-132, 6 FCC Rcd 5880, 5887 (1991) (business services market is now substantially competitive) with Signalling Order at para. 63 (declining to permit LECs to offer contract carriage because their services are not subject to substantial competition).

[89] Data in the Statistics of Communications of Common Carriers show that the LECs' Depreciation Reserve as a percentage of gross plant has risen from 25.1% in 1985 to 38.6% in 1992. Thus, the Commission has been increasing the

were allowed to use even higher depreciation rates, it would not depress their reported earnings permanently. Instead, would likely experience an effect on their earnings similar to that experienced by AT&T: their earnings would be adversely affected for one year, and then they would increase considerably.

**Baseline Issue 3c: The method the Commission should use to determine a revised and reasonable productivity factor.**

Some LECs argue that the Commission should ensure regulatory symmetry by adopting a similar productivity offset in the LEC price cap plan that it adopted for the cable television ("CATV") companies.[90] MCI disagrees. The LECs and the cable companies are in different industries, with disparate productivity experience. The Commission should set the productivity factor in each the LEC and CATV industries to reflect the individual productivity of the respective industries.

In sum, MCI believes the Commission should take into account all the available information regarding LEC productivity. Whether it re-examines its LEC productivity studies in light of LEC performance under price caps, as MCI suggests; or examines LEC performance under price caps, as AT&T and Ad Hoc recommends; or views LEC TFP performance for interstate services since the start of access charges, as USTA advocates, the conclusion is clear: LEC

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LECs' depreciation rates, as the LECs have been able to justify those increases.

[90] GTE Comments, p. 74; and Bell Atlantic Comments, p. 16. This productivity factor was 2%.

productivity has been substantially greater than is currently reflected in the LEC price cap plan. Therefore, MCI recommends that the Commission raise the productivity factor to 5.9 percent.

## BASELINE ISSUE 4: SHARING AND LOW-END ADJUSTMENT MECHANISM

**Baseline Issue 4a: Whether and how the sharing and low-end adjustment mechanisms should be realigned with capital costs.**

In its comments, MCI argued that the sharing and low end adjustment ranges be shifted to reflect the lower cost of capital now in effect.[91] Specifically, MCI recommended that (if the Commission retains the sharing and lower formula adjustment mechanism, the low end adjustment level should be set at 8.54 percent; the 50 percent sharing level, at 10.54 percent; and the 100 percent sharing level, at 14.54 percent.[92] MCI based this recommendation on a study it commissioned that determined that the LECs' current cost of capital is 9.54 percent.[93] This study used the same methodology as the Commission did in 1991 to determine the LECs' current midpoint of the sharing zone, 11.25 percent.

Although no other commenting party examined the current cost of capital, AT&T reviewed the BOCs' cost of capital for the period 1991-1993 using a similar methodology. That study determined that the BOCs' cost of capital fell steadily

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[91] MCI Comments, p. 29.

[92] Id. at 30.

[93] Id. at Appendix A.

during that period. The average for the entire period is 9.93 percent; for 1993, the rate of return is 9.33 percent.[94]

Taken together, MCI's and AT&T'S two studies provide strong evidence that the LECs' cost of capital has declined to around 9.5 percent. Thus, MCI urges the Commission to reset the sharing levels around this rate of return.

The LECs, however, claim that changes in the cost of capital already are reflected in the GNP-PI, and that no adjustment is necessary.[95] MCI disagrees. First, the timing of the supposed linkage posited by the LECs between changes in the cost of capital and the GNP-PI is not explained. Cost of capital has declined steadily over the last several years beginning prior to the initiation of price caps, and it cannot be demonstrated that the effects of any decline in the general price level caused by declines in the cost of capital were ever included in recent price cap adjustments.

Second, and more fundamental, the capital intensity of different industries is quite varied, and the GNP-PI will at best only reflect the average capital intensity nationwide, not the capital intensity of the LECs subject to price cap regulation. As a result, any effects of declining capital costs that may be captured in declines in the GNP-PI will not be an appropriate benchmark for determining whether LEC rates are just and reasonable. Moreover, to the extent the LECs

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[94] AT&T Comments, p. 31 and Appendix D.

[95] See, e.g., BellSouth Comments, p. 48; Pacific Telesis Comments, p. 45; and Bell Atlantic Comments, p. 13.

earn a return on the book value of their assets, which may well exceed their economic value, the appropriate price adjustment to account for a decline in the cost of capital will be correspondingly greater than for the economy as a whole, wherein competitive pressure prevents firms from earning a return on non-economic assets.

Finally, the LEC productivity factor was set based on productivity studies that held the LECs' cost of capital constant.[96] Therefore, to reflect a change in the LECs' cost of capital since the initialization of price caps, the Commission must order an explicit adjustment to be made to the price cap,, exclusive of a productivity adjustment that recaptures a portion of the LECs' productivity gains for ratepayers.

**Baseline Issue 4b: Whether the sharing and low-end adjustment mechanisms should be revised or eliminated.**

In its comments, MCI contended that the price cap sharing mechanism should be retained because "market and economic risk and uncertainty continue to exist, and as the LECs continue to pursue individual courses, the likelihood of earnings deviations among them increases."[97] In addition, MCI urged the

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[96] The Commission's short-term study (Appendix C) explicitly held the LECs' rate of return constant. The long-term study noted that apparent variations in productivity performance by the LECs corresponded to periods of overearnings or underearnings (Appendix B). Effectively, this means that the rate of return was held constant under this study as well. LEC Price Cap Order, 5 FCC Rcd at 6797-98.

[97] MCI Comments, p. 31.

Commission to eliminate the lower formula adjustment mechanism since other safety nets are available to the LECs that prevent confiscatory rate levels.[98] Finally, MCI reiterated its concern that the LECs have manipulated the sharing mechanism by booking higher expenses in the fourth quarter to achieve a desired level of return, and MCI recommended a procedure to thwart this LEC behavior.[99]

The LECs support elimination of the lower formula adjustment mechanism. Their argument for discarding it is the same as MCI's: the LECs have adequate protection against unreasonably low earnings from other aspects of the price cap plan, such as their ability to make above-cap filings.[100] AT&T also supports elimination of the lower formula adjustment mechanism, on the grounds that experience has shown that the LECs do not need protection against low earnings. and because the lower formula adjustment mechanism has allowed the LECs to raise their price cap indexes.[101] MCI urges the Commission to eliminate the lower formula adjustment mechanism in response to this unanimous support.

For several reasons the LECs also advocate elimination of the sharing mechanism. First, they claim the existence of sharing makes it difficult for the

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[98] Id. at 32.

[99] Id. at 34

[100] See, e.g., US WEST Comments, p. 47; USTA Comments, p. 51; Ameritech Comments, p. 16; Southwestern Bell Comments, p. 47; and Sprint Comments, pp. 14-15.

[101] AT&T Comments, p. 30.